Chapter- 2 Conceptual Framework of Indian Capital Market

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2.1 Introduction

After going through the background and Perspective Framework of the Study in the previous chapter, it is very important to go through the Conceptual Framework of Indian Capital Market. The conceptual framework of the capital market is thoroughly studied in this chapter, which includes historical background, components, structure and its regulatory framework.

"The capital market is a place where the suppliers and users of capital meet to share one another's views, and where a balance is sought to be achieved among diverse market participants. The securities decouple individual acts of saving and investment over time, space and entities and thus allow savings to occur without concomitant investment. Moreover, yield-bearing securities makes present consumption more expensive relative to future consumption, inducing people to save. The composition of savings changes with less of it being held in the form of idle money or unproductive assets, primarily because more divisible and liquid assets are available. The capital market acts as a brake on channeling savings to low-yielding enterprises and impels enterprises to focus on performance. It continuously monitors the performance through movements of share prices in the market and the threats of takeover. This improves efficiency of resource utilization and thereby significantly increases returns on investment. As a result, savers and investors are not constrained by their individual abilities, but facilitated by the economy's capability to invest and save, which inevitably enhances savings and investment in the economy. Thus, the capital market converts a
given stock of investible resources into a larger flow of goods and services and augments economic growth. In fact, the literature is full of theoretical and empirical studies that have established causal robust (statistically significant) two-way relation between the developments in the securities market and economic growth. Given the significance of capital market and the need for the economy to grow at the projected over 8 per cent per annum, the managers of the Indian economy have been assiduously promoting the capital market as an engine of growth to provide an alternative yet efficient means of resource mobilization and allocation. Further, the global financial environment is undergoing unremitting transformation. Geographical boundaries have disappeared. The days of insulated and isolated financial markets are history. The success of any capital market largely depends on its ability to align itself with the global order. To realize national aspirations and keep pace with the changing times, the capital markets in India have gone through various stages of liberalization, bringing about fundamental and structural changes in the market design and operation, resulting in broader investment choices, drastic reduction in transaction costs, and efficiency, transparency, and safety as also increased integration with the global markets. The opening up of the economy for investment and trade, the dismantling of administered interest and exchange rates regimes and setting up of sound regulatory institutions have enabled this.  

2.2 History of Indian Capital Market

Indian Stock Markets are one of the oldest in Asia. Its history dates back to nearly 200 years ago. The earliest records of security dealings in India are meager and obscure. The East India Company was the dominant
institution in those days and business in its loan securities used to be transacted towards the close of the eighteenth century. By 1830's business on corporate stocks and shares in Bank and Cotton presses took place in Bombay. Though the trading list was broader in 1839, there were only half a dozen brokers recognized by banks and merchants during 1840 and 1850. The 1850's witnessed a rapid development of commercial enterprise and brokerage business attracted many men into the field and by 1860 the number of brokers increased into 60.

The history of the Indian capital markets and the stock market, in particular can be traced back to 1861 when the American Civil War began. The opening of the Suez Canal during the 1860s led to a tremendous increase in exports to the United Kingdom and United States. Several companies were formed during this period and many banks came to the fore to handle the finances relating to these trades. With many of these registered under the British Companies Act, the Stock Exchange, Mumbai, came into existence in 1875.\(^2\) It was an unincorporated body of stockbrokers, which started doing business in the city under a banyan tree. Business was essentially confined to company owners and brokers, with very little interest evinced by the general public. There had been much fluctuation in the stock market on account of the American war and the battles in Europe. Sir Premchand Roychand remained a kingpin for many years.

The Second World War broke out in 1939. It gave a sharp boom which was followed by a slump. But, in 1943, the situation changed radically, when India was fully mobilized as a supply base. On account of the restrictive controls on cotton, bullion, seeds and other commodities, those dealing in
them found in the stock market as the only outlet for their activities. They were anxious to join the trade and their number was swelled by numerous others. Many new associations were constituted for the purpose and Stock Exchanges in all parts of the country were floated.#3

"The Uttar Pradesh Stock Exchange Limited (1940), Nagpur Stock Exchange Limited (1940) and Hyderabad Stock Exchange Limited (1944) were incorporated. In Delhi two stock exchanges - Delhi Stock and Share Brokers' Association Limited and the Delhi Stocks and Shares Exchange Limited - were floated and later in June 1947, amalgamated into the Delhi Stock Exchange Association Limited."#4

Sir Phiroze Jeejeebhoy was another who dominated the stock market scene from 1946 to 1980. His word was law and he had a great deal of influence over both brokers and the government. He was a good regulator and many crises were averted due to his wisdom and practicality. The BSE building, icon of the Indian capital markets, is called P.J. Tower in his memory. The planning process started in India in 1951, with importance being given to the formation of institutions and markets The Securities Contract Regulation Act 1956 became the parent regulation after the Indian Contract Act 1872, a basic law to be followed by security markets in India. To regulate the issue of share prices, the markets have witnessed several golden times too.

Trading was at that time limited to a dozen brokers: their trading place was under a banyan tree in front of the Town Hall in Bombay. These stockbrokers organized an informal association in 1875-Native Shares and
Stock Brokers Association, Bombay. The stock exchanges in Calcutta and Ahmadabad, also industrial and trading centers, came up later. The Bombay Stock Exchange was recognized in May 1927 under the Bombay Securities Contracts Control Act, 1925.

2.3 Post Independence Scenario

The depression witnessed after the Independence led to closure of a lot of exchanges in the country. Lahore Stock Exchange was closed down after the partition of India, and later on merged with the Delhi Stock Exchange. Bangalore Stock Exchange Limited was registered in 1957 and got recognition only by 1963. Most of the other Exchanges were in a miserable state till 1957 when they applied for recognition under Securities Contracts (Regulations) Act, 1956. The Exchanges that were recognized under the Act with their geographical location, and the date of receiving government recognition are giving in the Table 2.1.
### Table 2.1 Recognized Stock Exchanges in India

<table>
<thead>
<tr>
<th>Serial No.</th>
<th>Name of the Exchange &amp; Location</th>
<th>Date of initial recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>The Stock Exchange, Mumbai</td>
<td>31-03-1957</td>
</tr>
<tr>
<td>2.</td>
<td>The Ahmadabad Stock Exchange Association Ltd.</td>
<td>16-09-1957</td>
</tr>
<tr>
<td>3.</td>
<td>The Calcutta Stock Exchange Ltd., Calcutta</td>
<td>10-10-1957</td>
</tr>
<tr>
<td>5.</td>
<td>The Delhi Stock Exchange Association Ltd., New Delhi</td>
<td>09-12-1957</td>
</tr>
<tr>
<td>6.</td>
<td>The Hyderabad Stock Exchange, Hyderabad</td>
<td>29-09-1958</td>
</tr>
<tr>
<td>7.</td>
<td>Madhya Pradesh Stock Exchange, Indore</td>
<td>24-12-1958</td>
</tr>
<tr>
<td>8.</td>
<td>Bangalore Stock Exchange Ltd., Bangalore</td>
<td>16-02-1963</td>
</tr>
<tr>
<td>10.</td>
<td>The Uttar Pradesh Stock Exchange Association Ltd., Kanpur</td>
<td>03-06-1982</td>
</tr>
<tr>
<td>11.</td>
<td>Pune Stock Exchange Ltd., Pune</td>
<td>02-09-1982</td>
</tr>
<tr>
<td>15.</td>
<td>The Magadh Stock Exchange Ltd., Patna</td>
<td>11-12-1980</td>
</tr>
<tr>
<td>19.</td>
<td>The Vadodara Stock Exchange Ltd., Baroda</td>
<td>05-01-1990</td>
</tr>
<tr>
<td>23.</td>
<td>Over The Counter Exchange of India(OTCEI), Mumbai</td>
<td>23-08-1994</td>
</tr>
<tr>
<td>24.</td>
<td>Inter Connected Stock Exchanges of India (ICSEI)</td>
<td>1999</td>
</tr>
</tbody>
</table>

**Sources:** Compiled from the websites of NSE and BSE
The capital market was not well organized and developed during the British rule because the British government was not interested in the economic growth of the country. As a result, many foreign companies depended on the London capital market for funds rather than on the Indian capital market.

"In the post-independence period also, the size of the capital market remained small. During the first and second five-year plans, the government's emphasis was on the development of the agricultural sector and public sector undertakings. The public sector undertakings were healthier than the private undertakings in terms of paid-up capital but their shares were not listed on the stock exchanges. Moreover, the Controller of Capital Issues (CCI) closely supervised and controlled the timing, composition, interest rates, pricing, allotment, and floatation costs of new issues. These strict regulations demotivated many companies from going public for almost four and a half decades."^5

In the 1950s, Century Textiles, Tata Steel, Bombay Dyeing, National Rayon, and Kohinoor Mills were the favorite scrips of speculators. As speculation became rampant, the stock market came to be known as 'Satta Bazaar'. Despite speculation, non-payment or defaults were not very frequent. The government enacted the Securities Contracts (Regulation) Act in 1956s was also characterized by the establishment of a network for the development of financial institutions and state financial corporations.

"The 1960s was characterized by wars and droughts in the country which led to bearish trends. These trends were aggravated by the ban in 1969
on forward trading and 'badla', technically called 'contracts for clearing.' 'Badla' provided a mechanism for carrying forward positions as well as borrowing funds. Financial institutions such as LIC and GIC helped to revive the sentiment by emerging as the most important group of investors. The first mutual fund of India, the Unit Trust of India (UTI) came into existence in 1964.6

"A capital market may be defined as an organized mechanism for effective and efficient transfer of money capital or financial resources from the investing parties, i.e., individuals or individual savers to the entrepreneurs (individuals or institutions) engaged in industry and commerce in the business either in the private or public sectors of an economy."7

As every country today is aiming at reaching the status of developed country, the most important input they require is the investment. Where do they get their investments? Capital Market is the place where the economy can pool up funds required for their investment needs. In the modern scenario of globalization Capital Market plays a vital role in any economy. The strong presence of Capital Market resembles the strength of the economy.

We can define Capital market as a place where longer maturity financial assets are traded. The term "emerging market" refers to the securities markets of a developing country and the use that country makes of international capital markets.
2.4 Components of Indian Capital Market

Coming to Indian context, the term capital market refers to only stock markets as per the common man’s ideology, but the capital markets have a much broader sense. Where as in global scenario, it consists of various markets such as:

- Government securities market
- Municipal bond market
- Corporate debt market
- Stock market
- Depository receipts market
- Mortgage and asset-backed securities market
- Financial derivates market
- Foreign exchange market

2.5 Structure of Indian Capital Market

In India, many of the above markets are not developed to the required extent, and some does not even exist. A capital market can provide huge impetus to the development of any economy. so, it can be said that the growth and sustainability of capital markets plays an important role towards the development of the economy. It is being observed that huge fluctuations are happening in Indian capital market in recent past, but with the help of proper mechanism, which is being observed in India and after examining various risk
factors involved in capital markets, we attempt to say that the growth which has been observed in Indian capital market in recent past is a reality, but not a myth.

In India the capital market consists of:

- Stock market

- Bonds, convertible debentures and debt market

- New issue market and merchant banking

There are no special markets for the trading of municipal bonds, asset backed securities, foreign exchange market and depository receipts market.

Right from the independence, thanks to steps initiated by the Indian government especially after the post liberalization era. A huge growth has been observed in the aspects of quality and quantity. Huge increase has been observed in the volumes of trade.

2.6 Role of Capital Market

As we know that capital markets play a vital role in Indian economy, the growth of capital markets will be helpful in raising the per-capita income of the individuals, decrease the levels of un-employment, and thus reducing the number of people who lie below the poverty line. With the increasing awareness in the people they start investing in capital markets with long-term orientations, which would provide capital inflows to the sectors requiring financial assistance. Any individual investor considers the following factors of risk while investing in the capital markets:
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1. Volatility risk and Risk of contagions: High volatility is the characteristic of any capital market, especially in emerging markets. They are immature and sometimes vulnerable to scandal. They often lack legal and judicial infrastructure to enforce the law. Accounting disclosure, trading and settlement practices may at times seem overly arbitrary and naïve. Against this backdrop, many emerging markets have had to cope with unprecedented inflows and outflows of capital. The sudden withdrawal of highly speculative, short-term capital has the potential of taking with it much of a market’s price support. Such sudden flights of capital triggered by events in one emerging market can spread instantly to other markets through contagion effects even when those markets have quite different conditions.

2. Liquidity risk: Many emerging markets are small and illiquid. Volumes of trade are quite low. This kind of thin trading often leads to higher costs because large transactions have a significant impact on the market. Thus, buyers of large blocks of shares may have to pay more to complete the transaction, and sellers may receive a lower price.

3. Clearing and settlement risk: Inadequate settlement procedures still exist in many of the emerging markets. They lead to high FAIL rates. A Fail occurs when a trade fails to settle on the settlement date.

4. Political risk: In most of the developing countries the political systems are less stable comparative to the developed countries. This scenario does not give the political system to concentrate more on the capital market happenings and restrict any kind of malfunctions or practices.
5. **Currency risk:** The trade in capital markets will be highly impacted by the fluctuations in the foreign exchange rates. The currencies of the emerging countries are not stable enough to compete with those of the developed countries. This leads towards unexpected losses for the investors in the markets.

6. **Limited disclosure and insufficient legal infrastructure:** As it is already mentioned earlier that disclosure levels will not be up to the required extent in emerging markets, the investors will not have a bright picture of the company in which they are investing, and this may lead towards losses.

Coming to the Indian context, we can say that a proper mechanism has been devised to face and sustain with all the above risks, after facing each of them in a practical way. Thus the growth, which has been seen in India capital market, can be said as a “sustainable growth”

### 2.7 Structure of Financial Market

The function of the financial market is to facilitate the transfer of funds from surplus sectors (lenders) to deficit sectors (borrowers). Normally, households have investible funds or savings, which they lend to borrowers in the corporate and public sectors whose requirement of funds far exceeds their savings. A financial market consists of investors or buyers of securities, borrowers or sellers of securities, intermediaries and regulatory bodies. Financial market does not refer to a physical location. Formal trading rules, relationships and communication networks for originating and trading financial securities link the participants in the market.
A. **Organized Money Market:** "Indian financial system consists of money market and capital market. The money market has two components - the organized and the unorganized. The organized market is dominated by commercial banks. The other major participants are the Reserve Bank of India, Life Insurance Corporation, General Insurance Corporation, Unit Trust of India, Securities Trading Corporation of India Ltd. and Discount and Finance House of India, other primary dealers, commercial banks and mutual funds. The core of the money market is the inter-bank call money market whereby short-term money borrowing/lending is effected to manage temporary liquidity mismatches. The Reserve Bank of India occupies a strategic position of managing market liquidity through open market operations of government securities, access to its accommodation, cost (interest rates), availability of credit and other monetary management tools. Normally, monetary assets of short-term nature, generally less than one year, are dealt in this market.

B. **Un-organized Money Market:** Despite rapid expansion of the organized money market through a large network of banking institutions that have extended their reach even to the rural areas, there is still an active unorganized market. It consists of indigenous bankers and moneylenders. In the unorganized market, there is no clear demarcation between short-term and long-term finance and even between the purposes of finance. The unorganized sector continues to provide finance for trade as well as personal consumption. The inability of the poor to meet the "creditworthiness" requirements of the banking
sector make them take recourse to the institutions that still remain outside the regulatory framework of banking. But this market is shrinking.®

“Financial Markets have several facets and are segregated into Capital and Money markets. Product based classification gives rise to segmentation of market into equity, debt, foreign exchange and futures. The debt market is much more popular than the equity markets in most parts of the world. In India the reverse has been true. This has been due to the dominance of the government securities in the debt market and that too, a market where government was borrowing at pre-announced coupon rates from basically a captive group of investors, such as banks. Thus there existed a passive internal debt management policy. This, coupled with automatic monetization of fiscal deficit prevented a deep and vibrant government securities market. The debt market in India comprises broadly two segments, viz., Government Securities Market and Corporate Debt Market. The latter is further classified as Market for PSU Bonds and Private Sector Bonds.

The market for government securities is the oldest and has the most outstanding securities, trading volume and number of participants. Over the years, there have been new products introduced by the RBI like zero coupon bonds, floating rate bonds, inflation indexed bonds, etc. The trading platforms for government securities are the "Negotiated Dealing System" and the Wholesale Debt Market (WDM) segment of National Stock Exchange (NSE) and Bombay Stock Exchange (BSE). The PSU bonds were generally treated as surrogates of sovereign paper, sometimes due to explicit guarantee of government, and often due to the comfort of government ownership. The
perception and reality are two different aspects. The listed PSU bonds are traded on the Wholesale Debt Market of NSE. The corporate bond market, in the sense of private corporate sector raising debt through public issuance in capital market, is only an insignificant part of the Indian Debt Market. A large part of the issuance in the non-Government debt market is currently on private placement basis.\textsuperscript{9}

The capital market consists of primary and secondary markets. The primary market deals with the issue of new instruments by the corporate sector such as equity shares, preference shares and debt instruments. Central and State governments, various public sector industrial units (PSUs), statutory and other authorities such as state electricity boards and port trusts also issue bonds/debt instruments.

The primary market in which public issue of securities is made through a prospectus is a retail market and there is no physical location. Offer for subscription to securities is made to investing community. The secondary market or stock exchange is a market for trading and settlement of securities that have already been issued. The investors holding securities sell securities through registered brokers/sub-brokers of the stock exchange. Investors who are desirous of buying securities purchase securities through registered brokers/sub-brokers of the stock exchange. It may have a physical location like a stock exchange or a trading floor.

Since 1995, trading in securities is screen-based and Internet-based trading has also made an appearance in India. The secondary market consists of 23 stock exchanges including the National Stock Exchange, Over-
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The secondary market provides a trading place for the securities already issued, to be bought and sold. It also provides liquidity to the initial buyers in the primary market to reoffer the securities to any interested buyer at any price, if mutually accepted. An active secondary market actually promotes the growth of the primary market and capital formation because investors in the primary market are assured of a continuous market and they can liquidate their investments.

2.8 Capital Market Participants

There are several major players in the primary market. These include the merchant bankers, mutual funds, financial institutions, foreign institutional investors (FIIs) and individual investors. In the secondary market, there are the stock brokers (who are members of the stock exchanges), the mutual funds, financial institutions, foreign institutional investors (FIIs), and individual investors. Registrars and Transfer Agents, Custodians and Depositories are capital market intermediaries that provide important infrastructure services for both primary and secondary markets.

2.9 Capital Market Regulation

It is important to ensure smooth working of capital market, as it is the arena where the players in the economic growth of the country. Various laws have been passed from time to time to meet this objective. The financial market in India was highly segmented until the initiation of reforms in 1992-93 on account of a variety of regulations and administered prices including barriers.
to entry. The reform process was initiated with the establishment of Securities and Exchange Board of India (SEBI).

"The Securities and Exchange Board of India (SEBI) was constituted on 12 April 1988 as a non-statutory body through an Administrative Resolution of the Government for dealing with all matters relating to development and regulation of the securities market and investor protection and to advise the government on all these matters. SEBI was given statutory status and powers through an Ordinance promulgated on January 30 1992. SEBI was established as a statutory body on 21 February 1992. The Ordinance was replaced by an Act of Parliament on 4 April 1992. The preamble of the SEBI Act, 1992 enshrines the objectives of SEBI – to protect the interest of investors in securities market and to promote the development of and to regulate the securities market. The statutory powers and functions of SEBI were strengthened through the promulgation of the Securities Laws (Amendment) Ordinance on 25 January 1995, which was subsequently replaced by an Act of Parliament."^{10}

"The legislative framework before SEBI came into being consisted of three major Acts governing the capital markets:

1. The Capital Issues Control Act 1947, which restricted access to the securities market and controlled the pricing of issues.

2. The Companies Act, 1956, which sets out the code of conduct for the corporate sector in relation to issue, allotment and transfer of securities, and disclosures to be made in public issues."
3. The Securities Contracts (Regulation) Act, 1956, which regulates transactions in securities through control over stock exchanges. In addition, a number of other Acts, e.g., the Public Debt Act, 1942, the Income Tax Act, 1961, the Banking Regulation Act, 1949, have substantial bearing on the working of the securities market. Capital Issues (Control) Act, 1947 The Act had its origin during the Second World War in 1943 when the objective of the Government was to pre-empt resources to support the War effort. Companies were required to take the Government's approval for tapping household savings. The Act was retained with some modifications as a means of controlling the raising of capital by companies and to ensure that national resources were channeled into proper lines, i.e., for desirable purposes to serve goals and priorities of the government, and to protect the interests of investors. Under the Act, any firm wishing to issue securities had to obtain approval from the Central Government, which also determined the amount, type and price of the issue. This Act was repealed and replaced by SEBI Act in 1992.\(^\text{11}\)

A. Securities Contracts (Regulation) Act, 1956

The previously self-regulated stock exchanges were brought under statutory regulation through the passage of the SC(R) A, which provides for direct and indirect control of virtually all aspects of securities trading and the running of stock exchanges. This gives the Central Government regulatory jurisdiction over (a) stock exchanges, through a process of recognition and continued supervision, (b) contracts in securities, and (c) listing of securities on stock exchanges. As a condition of recognition, a stock exchange complies with conditions prescribed by Central Government. Organized trading activity
in securities in an area takes place on a specified recognized stock exchange. The stock exchanges determine their own listing regulations which have to conform with the minimum listing criteria set out in the Rules. The regulatory jurisdiction on stock exchanges was passed over to SEBI on enactment of SEBI Act in 1992 from Central Government by amending SC(R) Act.

B. Companies Act, 1956

"Companies Act, 1956 is a comprehensive legislation covering all aspects of company form of business entity from formation to winding-up. This legislation (amongst other aspects) deals with issue, allotment and transfer of securities and various aspects relating to company management. It provides for standards of disclosure in public issues of capital, particularly in the fields of company management and projects, information about other listed companies under the same management, and management perception of risk factors. It also regulates underwriting, the use of premium and discounts on issues, rights and bonus issues, substantial acquisitions of shares, payment of interest and dividends, supply of annual report and other information.

This legal and regulatory framework contained many weaknesses. Jurisdiction over the securities market split among various agencies and the relevant was scattered in a number of statutes. This resulted in confusion, not only in the minds of the regulated but also among regulators. It also created inefficiency in the enforcement of the regulations. It was the Central Government rather than the market that allocated resources from the securities market to competing issuers and determined the terms of allocation. The allocation was not necessarily based on economic criteria, and as a result
the market was not allocating the resources to the best possible investments, leading to a sub-optimal use of resources and low allocational efficiency. Informational efficiency was also low because the provisions of the Companies Act regarding prospectus did not ensure the supply of necessary, adequate and accurate information, sufficient to enable investors to make an informed decision. The many formalities associated with the issue process under various regulations kept the cost of issue quite high. Under the SC(R)A, the secondary market was fragmented regionally, with each stock exchange a self-regulating organisation following its own policy of listing, trading and settlement. The listing agreement did not have the force of law, so that issuers could get away with violations. The interests of the brokers, who were market players and dominated the governing boards of stock exchanges, took priority over the interest of investors. The market was narrow and investors did not have an opportunity to have balanced portfolios.

The settlement of trades took a long time, because it required physical movement of securities, and the transfer of securities was very cumbersome under the Companies Act and SC(R) Act, thus depriving the investor of liquidity. Law expressly forbade options and futures. These weaknesses were corrected by passing SEBI Act and giving overall regulatory jurisdiction on capital market to SEBI. SEBI framed regulations and guidelines to improve efficiency of the market, enhance transparency, check unfair trade practices and ensure international standards in market practices necessitated by the large entry of foreign financial institutions. Securities and Exchange Board of India With the objectives of improving market efficiency, enhancing transparency, checking unfair trade practices and bringing the Indian market
up to international standards, a package of reforms consisting of measures to liberalise, regulate and develop the securities market was introduced during the 1990s. This has changed corporate securities market beyond recognition in this decade. The practice of allocation of resources among different competing entities as well as its terms by a central authority was discontinued. The secondary market overcame the geographical barriers by moving to screen-based trading. Trades enjoy counterparty guarantee. Physical security certificates have almost disappeared. The settlement period has shortened to three days. The following paragraphs discuss the principal reform measures undertaken since 1992.12

A major step in the liberalisation process was the repeal of the Capital Issues (Control) Act, 1947 in May 1992. With this, Government's control over issue of capital, pricing of the issues, fixing of premia and rates of interest, on debentures, etc., ceased. The office, which administered the Act, was abolished and the market was allowed to allocate resources to competing uses and users. Indian companies were allowed access to international capital market through issue of ADRs and GDRs. However, to ensure effective regulation of the market, SEBI Act, 1992 was enacted to empower SEBI with statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market. Its regulatory jurisdiction extends over corporate in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. SEBI can specify the matters to be disclosed and the standards of disclosure required for the protection of investors in respect of issues. It can issue directions to all
intermediaries and other persons associated with the securities market in the interest of investors or of orderly development of the securities market; and can conduct inquiries, audits and inspection of all concerned and adjudicate offences under the Act. In short, it has been given necessary autonomy and authority to regulate and develop an orderly securities market.

There were several statutes regulating different aspects of the securities market and jurisdiction over the securities market was split among various agencies, whose roles overlapped and which at times worked at cross-purposes. As a result, there was no coherent policy direction for market participants to follow and no single supervisory agency had an overview of the securities business. Enactment of SEBI Act was the first such attempt towards integrated regulation of the securities market. SEBI was given full authority and jurisdiction over the securities market under the Act, and was given concurrent/delegated powers for various provisions under the Companies Act and the SC(R)A. The Depositories Act, 1996 is also administered by SEBI. A high level committee on capital markets has been set up to ensure co-ordination among the regulatory agencies in financial markets.

In the interest of investors, SEBI issued Disclosure and Investor Protection (DIP) Guidelines. Issuers are now required to comply with these Guidelines before accessing the market. The guidelines contain a substantial body of requirements for issuers/intermediaries. The main objective is to ensure that all concerned observe high standards of integrity and fair dealing, comply with all the requirements with due skill, diligence and care, and disclose the truth, the whole truth and nothing but the truth. The Guidelines aim to secure fuller disclosure of relevant information about the issuer and the nature of the
securities to be issued so that investor can take an informed decision. For example, issuers are required to disclose any material 'risk factors' in their prospectus and the justification for the pricing of the securities has to be given. SEBI has placed a responsibility on the lead managers to give a due diligence certificate, stating that they have examined the prospectus, that they find it in order and that it brings out all the facts and does not contain anything wrong or misleading. Though the requirement of vetting has now been dispensed with, SEBI has raised standards of disclosures in public issues to enhance the level of investor protection.

**Improved Disclosures by Listed Companies:** The norms for continued disclosure by listed companies have also improved the availability of timely information. The information technology helped in easy dissemination of information about listed companies and market intermediaries. Equity research and analysis and credit rating have improved the quality of information. SEBI has recently started a system for Electronic Data Information Filing and Retrieval System (EDIFAR) to facilitate electronic filing of public domain information by companies.

**Introduction of Derivatives:** "To assist market participants to manage risks better through hedging, speculation and arbitrage, SC(R) A was amended in 1995 to lift the ban on options in securities. However, trading in derivatives did not take off, as there was no suitable legal and regulatory framework to govern these trades. Besides, it needed a lot of preparatory work - the underlying cash markets needed to be strengthened with the assistance of the automation of trading and of the settlement system; the exchanges developed adequate infrastructure and the information systems required to implement
trading discipline in derivative instruments. The SC(R) A was amended further in December 1999 to expand the definition of securities to include derivatives so that the whole regulatory framework governing trading of securities could apply to trading of derivatives also. A three-decade old ban on forward trading, which had lost its relevance and was hindering introduction of derivatives trading, was withdrawn. Derivative trading took off in June 2000 on two exchanges. Now different types of derivative contracts i.e. index future, index options, single stock futures and single stock options are available in the market.\(^\text{13}\)

Even before the crisis of 1991, there had been a demand from domestic financial institutions (DFIs) to reform Indian equity markets. Liquidity on the exchanges lacked the depth the DFIs needed to execute large transactions. They also faced problems with brokers front-running against their orders, or the lack of resilience of liquidity once it was known that the DFIs had placed orders in the market.

These problems in secondary market liquidity led to a first attempt to innovate on a design for the equity markets. This attempt was made by the DFIs and became the Over the Counter Exchange of India, Ltd. (OTCEI). OTCEI was inspired by the NASDAQ system of using multiple, competing market makers. This exchange started as a national market that was limited to trading shares that had very low liquidity on the existing exchanges. OTCEI was unable to create a liquid market and was ultimately considered a failure in financial institution building.
However, OTCEI had a significant role to play in the reforms that followed. The first lesson learnt was that the failure of the OTCEI stemmed from problems of transplanting an international market design into India. Second, it reinforced the idea that an effort by the government to create viable financial market institutions was not credible. This raised the level of complacency among the incumbent exchanges and incumbent brokers about future attempts by the government to build a competing exchange. These lessons shaped the next attempts in market reforms.

The governing bodies of stock exchanges used to be dominated by brokers, leading inevitably to conflicts of interest. To discipline brokers and cure typical stock market ills such as price rigging, it was considered necessary for stock exchanges to have a professionally managed environment. NSE started with the concept of an independent governing body without any broker representation. It was specified in 1993 that the governing boards of stock exchanges must have 50% non-broker members, and that on committees handling matters of discipline, default, etc., brokers would be in the minority. All stock exchanges were mandated to appoint a non-broker executive director who would be accountable to SEBI for implementing the policy directions of the Central Government/SEBI. In course of time, the position of the executive director in the management of stock exchange has been strengthened. Indian securities market is getting increasingly integrated with the rest of the world. FIs have been permitted to invest in all types of securities, including government securities. Indian companies have been permitted to raise resources from abroad through issue of ADRs, GDRs, FCCBs and ECBs. Reserve Bank of India has recently allowed the limited
two-way fungibility for the subscribers of these instruments. Indian stock exchanges have been permitted to set up trading terminals abroad. The trading platform of Indian exchanges can now be accessed through the Internet from anywhere in the world. In line with the global phenomena, Indian capital markets have also moved to rolling settlements on a T+2 basis where trades are settled on the second day after trading.

2.10 National Stock Exchange

"The National Stock Exchange was set up in 1992 as a first step in reforming the securities market through improved technology and introduction of best practices in management. It started with the concept of an independent governing body without any broker representation thus ensuring that the operators’ interests were not allowed to dominate the governance of the exchange. There were two guiding principles that drove the design of the new exchange: first, that the price discovery process should be as transparent as possible; second, the exchange should support competition - there should be equal access for all equity market participants. The salient features that differentiated the design of the NSE from the existing exchanges were:

1. National platform that offered equal access to traders from all corners of a wide-spread geographical area.
2. A competitive market in securities intermediation, with a steady pace of entry and exit.
3. Orders matched electronically, on the basis of price-time priority.
5. Demoralized governance structure, as opposed to being an association of brokers, with a professional management team running the operations of the exchange."^{14}

"NSE has remained in the forefront of modernization of India’s capital and financial markets, and its pioneering efforts include:

- Being the first national, anonymous, electronic limit order book (LOB) exchange to trade securities in India. Since the success of the NSE, existent market and new market structures have followed the "NSE" model.
- Setting up the first clearing corporation "National Securities Clearing Corporation Ltd." in India. NSCCL was a landmark in providing innovation on all spot equity market (and later, derivative market) trades in India.
- Co-promoting and setting up of National Securities Depository Limited, first depository in India.
- Setting up of S&P CNX Nifty.
- NSE pioneered commencement of Internet Trading in February 2000, which led to the wide popularization of the NSE in the broker community.
- Being the first exchange that, in 1996, proposed exchange traded derivatives, particularly on an equity index, in India. After four years of policy and regulatory debate and formulation, the NSE was permitted to start trading equity derivatives.
- Being the first and the only exchange to trade GOLD ETFs (exchange traded funds) in India.
NSE has also launched the NSE-CNBC-TV18 media centre in association with CNBC-TV18.15

2.11 Milestones of NSE

Nov. 1992  Incorporation
April 1993  Recognition as a stock exchange
May 1993  Formulation of business plan
June 1994  Wholesale Debt Market segment goes live
Nov. 1994  Capital Market (Equities) segment goes live
March 1995  Establishment of Investor Grievance Cell
April 1995  Establishment of NSCCL, the first Clearing Corporation
June 1995  Introduction of centralized insurance cover for all trading members
July 1995  Establishment of Investor Protection Fund
Oct. 1995  Became largest stock exchange in the country
April 1996  Commencement of clearing and settlement by NSCCL
April 1996  Launch of S&P CNX Nifty
June 1996  Establishment of Settlement Guarantee Fund
Nov. 1996  Setting up of National Securities Depository Limited, first depository in India, co-promoted by NSE
Nov. 1996  Best IT Usage award by Computer Society of India
Dec. 1996  Commencement of trading/settlement in dematerialized securities
Dec. 1996  Dataquest award for Top IT User
Dec. 1996  Launch of CNX Nifty Junior
Feb. 1997  Regional clearing facility goes live
Chapter-2  Conceptual Framework of Indian Capital Market

Nov. 1997  Best IT Usage award by Computer Society of India

May 1998  Promotion of joint venture, India Index Services & Products Limited (IISL)

May 1998  Launch of NSE's Web-site: www.nse.co.in

July 1998  Launch of NSE's Certification Programme in Financial Market


Feb. 1999  Launch of Automated Lending and Borrowing Mechanism

April 1999  CHIP Web Award by CHIP magazine

Oct. 1999  Setting up of NSE.IT

Jan. 2000  Launch of NSE Research Initiative

Feb. 2000  Commencement of Internet Trading

June 2000  Commencement of Derivatives Trading (Index Futures)

Sept. 2000  Launch of 'Zero Coupon Yield Curve'

Nov. 2000  Launch of Broker Plaza by Dotex International, a joint venture between NSE.IT Ltd. and I-flex Solutions Ltd.

Dec. 2000  Commencement of WAP trading

June 2001  Commencement of trading in Index Options

July 2001  Commencement of trading in Options on Individual Securities

Nov. 2001  Commencement of trading in Futures on Individual Securities

Dec. 2001  Launch of NSE VaR for Government Securities

Jan. 2002  Launch of Exchange Traded Funds (ETFs)

May 2002  NSE wins the Wharton-Infosys Business Transformation Award in the Organization-wide Transformation category

Oct. 2002  Launch of NSE Government Securities Index

Jan. 2003  Commencement of trading in Retail Debt Market
June 2003   Launch of Interest Rate Futures
Aug. 2003   Launch of Futures & options in CNXIT Index
June 2004   Launch of STP Interoperability
Aug. 2004   Launch of NSE’s electronic interface for listed companies
Mar. 2005   'India Innovation Award' by EMPI Business School, New Delhi
June 2005   Launch of Futures & options in BANK Nifty Index
Dec. 2006   'Derivative Exchange of the Year', by Asia Risk magazine
Jan. 2007   Launch of NSE – CNBC TV 18 media centre
Mar. 2007   NSE, CRISIL announce launch of IndiaBondWatch.com
June 2007   NSE launches derivatives on Nifty Junior & CNX 100
Oct. 2007   NSE launches derivatives on Nifty Midcap 50
Mar. 2008   Introduction of long term option contracts on S&P Nifty Index
April 2008  Launch of India VIX
April 2008  Launch of Securities Lending & Borrowing Scheme

"Before the NSE was set up, trading on the stock exchanges in India used to take place through open outcry without use of information technology for immediate matching or recording of trades. This was time consuming and inefficient. The practice of physical trading imposed limits on trading volumes and, hence, the speed with which new information was incorporated into prices. To obviate this, the NSE introduced screen-based trading system (SBTS) where a member can punch into the computer the quantities of shares and the prices at which he wants to transact. The transaction is executed as soon as the quote punched by a trading member finds a matching sale or buy quote from counterparty. SBTS electronically matches the buyer and seller in
an order-driven system or finds the customer the best price available in a quote-driven system, and, hence, cuts down on time, cost and risk of error, as well as on the chances of fraud. SBTS enables distant participants to trade with each other, improving the liquidity of the markets. The high speed with which trades are executed and the large number of participants who can trade simultaneously allows faster incorporation of price sensitive information into prevailing prices. This increases the informational efficiency of markets. With SBTS, it becomes possible for market participants to see the full market, which helps to make the market more transparent, leading to increased investor confidence. The NSE started nation-wide SBTS, which have provided a completely transparent trading mechanism. Regional exchanges lost a lot of business to NSE, forcing them to introduce SBTS. Today, India can boast that almost 100% trading take place through electronic order matching.\textsuperscript{16}

Prior to the setting up of NSE, trading on stock exchanges in India took place without the use of information technology for immediate matching or recording of trades. The practice of physical trading imposed limits on trading volumes as well as the speed with which the new information was incorporated into prices. The unscrupulous operators used this information asymmetry to manipulate the market. The information asymmetry helped brokers to perpetrate a manipulative practice known as "gala". Gala is a practice of extracting highest price of the day for "buy" transaction irrespective of the actual price at which the purchase was actually done and give lowest price of the day for "sell" transactions irrespective of the price at which sale was made. The clients did not have any method of verifying the actual price. The electronic and now fully online trading introduced by the NSE has made
such manipulation difficult. It has also improved liquidity and made the entire operation more transparent and efficient. The NSE has set up a clearing corporation to provide legal counterparty guarantee to each trade thereby eliminating counterparty risk. The National Securities Clearing Corporation Ltd. (NSCCL) commenced operations in April 1996. Counterparty risk is guaranteed through fine-tuned risk management systems and an innovative method of on-line position monitoring and automatic disablement. Principle of "novation" is implemented by NSE capital market segment. Under this principle, NSCCL is the counterparty for every transaction and, therefore, default risk is minimized. To support the assured settlement, a "settlement guarantee fund" has been created. A large settlement guarantee fund provides a cushion for any residual risk. As a consequence, despite the fact that the daily traded volumes on the NSE run into thousands of crores of rupees, credit risk no longer poses any problem in the marketplace.

2.12 Depository System

"The erstwhile settlement system on Indian stock exchanges was also inefficient and increased risk, due to the time that elapsed before trades were settled. The transfer was by physical movement of papers. There had to be a physical delivery of securities -a process fraught with delays and resultant risks. The second aspect of the settlement related to transfer of shares in favor of the purchaser by the company. The system of transfer of ownership was grossly inefficient as every transfer involves physical movement of paper securities to the issuer for registration, with the change of ownership being evidenced by an endorsement on the security certificate. In many cases the process of transfer would take much longer than the two months stipulated in
the Companies Act, and a significant proportion of transactions would end up as bad delivery due to faulty compliance of paper work. Theft, forgery, mutilation of certificates and other irregularities were rampant. In addition, the issuer had the right to refuse the transfer of a security. All this added to costs and delays in settlement, restricted liquidity and made investor grievance redress time consuming and, at times, intractable. To obviate these problems, the Depositories Act, 1996 was passed. It provides for the establishment of depositories in securities with the objective of ensuring free transferability of securities with speed, accuracy and security. It does so by (a) making securities of public limited companies freely transferable subject to certain exceptions; (b) dematerializing the securities in the depository mode; and (c) providing for maintenance of ownership records in a book entry form. In order to streamline both the stages of settlement process, the Act envisages transfer ownership of securities electronically by book entry without making the securities move from person to person. The Act has made the securities of all public limited companies freely transferable, restricting the company’s right to use discretion in effecting the transfer of securities, and the transfer deed and other procedural requirements under the Companies Act have been dispensed with. Two depositories, viz., NSDL and CDSL, have come up to provide instantaneous electronic transfer of securities.”17

In any stock exchange, trades or transactions have to be settled by either squaring up the carrying forward positions or settling by payment of net cash or net delivery of securities. This account settlement period, if it is long, leads to several price distortions and allows for market manipulation. It increases the chances of speculation resulting in volatility, which hurts the
small investors. With the application of IT in the securities market - screen-based trading and trading through the Internet - it has been possible to reduce this settlement period.

2.13 Testing and Certification

"A critical element of financial sector reforms is the development of a pool of human resources having the skills and expertise to provide quality intermediation services in each segment of the industry. In order to dispense quality intermediation, personnel working in the industry need to (a) follow certain code of conduct usually achieved through regulations and (b) possess requisite skills and knowledge generally acquired through a system of testing and certification. It is necessary that they have a proper understanding of the business and skills to help it remain competitive. Such testing and certification has assumed added significance in India as there is no formal education/training on financial markets, especially in the area of market operations which have undergone a complete transformation in the recent years. Taking into account international experience and needs of the financial markets, NSE launched NCFM (NSE's Certification in Financial Markets). It tests practical knowledge and skills that are required to operate in financial markets, in a very secure and unbiased manner, and certifies personnel with a view to improve quality of intermediation. This has gained market acceptability, as there is a realization that the financial markets are soon going to be the turf of certified professionals due to regulatory compulsions and/or initiatives of the industry. By imparting comprehensive knowledge and skill in the chosen field, NCFM enhances career opportunities for NCFM certified persons and allows
market participants and intermediaries to build their own staff development strategies tailored to their specific needs.¹⁸

2.14 Capital Market Intermediaries

There are several institutions, which facilitate the smooth functioning of the securities market. They enable the issuers of securities to interact with the investors in the primary as well as the secondary arena.

A. Merchant Bankers

"Among the important financial intermediaries are the merchant bankers. The services of merchant bankers have been identified in India with just issue management. It is quite common to come across reference to merchant banking and financial services as though they are distinct categories. The services provided by merchant banks depend on their inclination and resources - technical and financial. Merchant bankers (Category 1) are mandated by SEBI to manage public issues (as lead managers) and open offers in take-overs. These two activities have major implications for the integrity of the market. They affect investors' interest and, therefore, transparency has to be ensured. These are also areas where compliance can be monitored and enforced. Merchant banks are rendering diverse services and functions. These include organizing and extending finance for investment in projects, assistance in financial management, acceptance house business, raising Euro-dollar loans and issue of foreign currency bonds. Different merchant bankers specialize in different services. However, since they are one of the
major intermediaries between the issuers and the investors, their activities are regulated by


(2) Guidelines of SEBI and Ministry of Finance.

(3) Companies Act, 1956.

(4) Securities Contracts (Regulation) Act, 1956.

Merchant banking activities, especially those covering issue and underwriting of shares and debentures, are regulated by the Merchant Bankers Regulations of Securities and Exchange Board of India (SEBI). SEBI has made the quality of manpower as one of the criteria for renewal of merchant banking registration. These skills should not be concentrated in issue management and underwriting alone. The criteria for authorization take into account several parameters. These include: (a) professional qualification in finance, law or business management, (b) infrastructure like adequate office space, equipment and manpower, (c) employment of two persons who have the experience to conduct the business of merchant bankers, (d) capital adequacy and (e) past track record, experience, general reputation and fairness in all their transactions.

SEBI authorizes merchant bankers for an initial period of three years, if they have a minimum net worth of Rs. 5 crore. An initial authorization fee, an annual fee and renewal fee is collected by SEBI. According to SEBI, all issues should be managed by at least one authorized merchant banker functioning as the sole manager or lead manager. The lead manager should not agree to
manage any issue unless his responsibilities relating to the issue, mainly disclosures, allotment and refund, are clearly defined. A statement specifying such responsibilities has to be furnished to SEBI. SEBI prescribes the process of due diligence that a merchant banker has to complete before a prospectus is cleared. It also insists on submission of all the documents disclosing the details of account and the clearances obtained from the ROC and other government agencies for tapping peoples' savings. The responsibilities of lead manager, underwriting obligations, capital adequacy, due diligence certification, etc., are laid down in detail by SEBI. The objective is to facilitate the investors to take an informed decision regarding their investments and not expose them to unknown risks.

B. Credit Rating Agencies

"The 1990s saw the emergence of a number of rating agencies in the Indian market. These agencies appraise the performance of issuers of debt instruments like bonds or fixed deposits. The rating of an instrument depends on parameters like business risk, market position, operating efficiency, adequacy of cash flows, financial risk, financial flexibility, and management and industry environment.

The objective and utility of this exercise is twofold. From the point of view of the issuer, by assigning a particular grade to an instrument, the rating agencies enable the issuer to get the best price. Since all financial markets are based on the principle of risk/reward, the less risky the profile of the issuer of a debt security, the lower the price at which it can be issued. Thus, for the issuer, a favorable rating can reduce the cost of borrowed capital. From the
viewpoint of the investor, the grade assigned by the rating agencies depends on the capacity of the issuer to service the debt. It is based on the past performance as well as an analysis of the expected cash flows of a company when viewed on the industry parameters as well as company performance. Hence, the investor can judge for himself whether he wants to place his savings in a "safe" instrument and get a lower return or he wants to take a risk and get a higher return.\(^{20}\)

The 1990s saw an increase in activity in the primary debt market. Under the SEBI guidelines all issuers of debt have to get the instruments rated. They also have to prominently display the ratings in all that marketing literature and advertisements. The rating agencies have thus become an important part of the institutional framework of the Indian securities market. R& T Agents - Registrars to Issue R&T Agents form an important link between the investors and issuers in the securities market.

A company, whose securities are issued and traded in the market, is known as the Issuer. The R&T Agent is appointed by the Issuer to act on its behalf to service the investors in respect of all corporate actions like sending out notices and other communications to the investors as well as dispatch of dividends and other non-cash benefits. R&T Agents perform an equally important role in the depository system as well. These are described in detail in the second section of this Workbook.

C. Stock Brokers

"Stockbrokers are the intermediaries who are allowed to trade in securities on the exchange of which they are members. They buy and sell on
their own behalf as well as on behalf of their clients. Traditionally, in India, individuals owned firms providing brokerage services or they were partnership firms with unlimited liabilities. There were, therefore, restrictions on the amount of funds they could raise by way of debt. With increasing volumes in trading as well as in the number of small investors, lack of adequate capitalisation of these firms exposed investors to the risks of these firms going bust and the investors would have no recourse to recovering their dues. With the legal changes being effected in the membership rules of stock exchanges as well as in the capital gains structure for stock-broking firms, a number of brokerage firms have converted themselves into corporate entities. In fact, NSE encouraged the setting up of corporate broking members and has today has only 10% of its members who are not corporate entities. ²¹

D. Custodian of Securities

"In the earliest phase of capital market reforms, to get over the problems associated with paper-based securities, large holding by institutions and banks were sought to be immobilized. Immobilization of securities is done by storing or lodging the physical security certificates with an organisation that acts as a custodian - a securities depository. All subsequent transactions in such immobilized securities take place through book entries. The actual owners have the right to withdraw the physical securities from the custodial agent whenever required by them. In the case of IPO, a jumbo certificate is issued in the name of the beneficiary owners based on which the depository gives credit to the account of beneficiary owners. The Stock Holding Corporation of India was set up to act as a custodian for securities of a large number of banks and institutions who were mainly in the public sector. Some
of the banks and financial institutions also started providing "Custodial" services to smaller investors for a fee. With the introduction of dematerialization of securities there has been a shift in the role and business operations of Custodians. But they still remain an important intermediary providing services to the investors who still hold securities in a physical form.22

E. Mutual Funds

Mutual funds are financial intermediaries, which collect the savings of small investors and invest them in a diversified portfolio of securities to minimize risk and maximize returns for their participants. Mutual funds have given a major fillip to the capital market - both primary as well as secondary. The units of mutual funds, in turn, are also tradable securities. Their price is determined by their net asset value (NAV) which is declared periodically. The operations of the private mutual funds are regulated by SEBI with regard to their registration, operations, administration and issue as well as trading.

There are various types of mutual funds, depending on whether they are open ended or close ended and what their end use of funds is. An open-ended fund provides for easy liquidity and is a perennial fund, as its very name suggests. A closed-ended fund has a stipulated maturity period, generally five years. A growth fund has a higher percentage of its corpus invested in equity than in fixed income securities, hence, the chances of capital appreciation (growth) are higher. In Growth Funds, the dividend accrued, if any, is reinvested in the fund for the capital appreciation of investments made by the investor. An Income fund on the other hand invests
a larger portion of its corpus in fixed income securities in order to pay out a portion of its earnings to the investor at regular intervals. A balanced fund invests equally in fixed income and equity in order to earn a minimum return to the investors. Some mutual funds are limited to a particular industry; others invest exclusively in certain kinds of short-term instruments like money market or Government securities. These are called money market funds or liquid funds. To prevent processes like dividend stripping or to ensure that the funds are available to the managers for a minimum period so that they can be deployed to at least cover the administrative costs of the asset management company, mutual funds prescribe an entry load or an exit load for the investors. If investors want to withdraw their investments earlier than the stipulated period, an exit load is chargeable. To prevent profligacy, SEBI has prescribed the maximum that can be charged to the investors by the fund managers."

F. Depositories

"The depositories are important intermediaries in the securities market that is scrip-less or moving towards such a state. In India, the Depositories Act defines a depository to mean "a company formed and registered under the Companies Act, 1956 and which has been granted a certificate of registration under sub-section (IA) of section 12 of the Securities and Exchange Board of India Act, 1992." The principal function of a depository is to dematerialize securities and enable their transactions in book-entry form. Dematerialization of securities occurs when securities, issued in physical form, are destroyed and an equivalent number of securities are credited into the beneficiary owner's account. In a depository system, the investors stand to
gain by way of lower costs and lower risks of theft or forgery, etc. They also benefit in terms of efficiency of the process. But the implementation of the system has to be secure and well governed. All the players have to be conversant with the rules and regulations as well as with the technology for processing. The intermediaries in this system have to play strictly by the rules.

A depository established under the Depositories Act can provide any service connected with recording of allotment of securities or transfer of ownership of securities in the record of a depository. A depository cannot directly open accounts and provide services to clients. Any person willing to avail of the services of the depository can do so by entering into an agreement with the depository through any of its Depository Participants.

**G. Depository Participants**

A Depository Participant (DP) is described as an agent of the depository. They are the intermediaries between the depository and the investors. The relationship between the DPs and the depository is governed by an agreement made between the two under the Depositories Act. In a strictly legal sense, a DP is an entity who is registered as such with SEBI under the provisions of the SEBI Act. As per the provisions of this Act, a DP can offer depository related services only after obtaining a certificate of registration from SEBI. SEBI (D&P) Regulations, 1996 prescribe a minimum net worth of Rs. 50 lakh for stockbrokers, R&T agents and non-banking finance companies (NBFC), for granting them a certificate of registration to act as DPs. If a stockbroker seeks to act as a DP in more than one depository, he should comply with the specified net worth criterion separately for each such depository. No minimum net worth criterion has been prescribed for other
categories of DPs. However, depositories can fix a higher net worth criterion for their DPs. NSDL requires a minimum net worth of Rs. 100 lakh to be eligible to become a DP as against Rs. 50 lakh prescribed by SEBI (D&P) Regulations. 24

H. Depository Participants

The changes in the regulatory framework of the capital market and fiscal policies have also resulted in newer kinds of financial instruments (securities) being introduced in the market. Also, a lot of financial innovation by companies who are now permitted to undertake treasury operations, has resulted in newer kinds of instruments - all of which can be traded – being introduced. The variations in all these instruments depend on the tenure, the nature of security, the interest rate, the collateral security offered and the trading features, etc.

I. Debentures

These are issued by companies and regulated under the SEBI guidelines of June 11, 1992. These are issued under a prospectus, which has to be approved by SEBI like in the case of equity issues. The rights of investors as debenture holders are governed by the Companies Act, which prohibits the issue of debentures with voting rights. There are a large variety of debentures that is available. This includes:

- Participating debentures
- Convertible debentures with options
- Third party convertible debentures
• Debt/equity swaps

• Zero coupon convertible notes

• Secured premium notes

• Zero interest fully convertible debentures

• Fully convertible debentures with interest

• Partly convertible debentures.

J. Bonds

Indian DFIs, like IDBI, ICICI, and IFCI, have been raising capital for their operations by issuing of bonds. These too are available in a large variety. These include:

• Income bonds

• Tax-free bonds

• Capital gains bonds

• Deep discount bonds

• Infrastructure bonds

• Retirement bonds

In addition to the interest rates and maturity profiles of these instruments, the issuer institutions have been including a put/call option on especially the very long-dated bonds like deep discount bonds. Since the tenures of some of these instruments spanned some 20 or 25 years during
which the interest rate regimes may undergo a complete change, the issuer has kept the flexibility to retire the costly debt. This they do by exercising their option to redeem the securities at pre-determined periods like at the end of five or seven years. This has been witnessed in number of instruments recently much to the chagrin of investors who were looking for secure and hassle-free long-dated instruments."^25

K. Preference Shares

"As the name suggests, owners of preferential shares enjoy a preferential treatment with regard to corporate actions like dividend. They also have a higher right of repayment in case of winding up of a company. Preference shares have different features and are accordingly available as:

- **Cumulative and non-cumulative**

- **Participating**

- **Cumulative & Redeemable fully convertible to preference shares**

- **Cumulative & Redeemable fully convertible to equity**

- **Preference shares with warrants**

- **Preference shares**

L. Equity Shares

As the name indicates, these represent the proportionate ownership of the company. This right is expressed in the form of participation in the profits of the company. There has been some innovation in the way these
instruments are issued. Some hybrid securities like equity shares with detachable warrants are also available.26

M. Government Securities

The Central Government or State Governments issue securities periodically for the purpose of raising loans from the public. There are two types of Government Securities – Dated Securities and Treasury Bills. Dated Securities have a maturity period of more than one year. Treasury Bills have a maturity period of less than or up to one year. The Public Debt Office (PDO) of the Reserve Bank of India performs all functions with regard to the issue management, settlement of trade, distribution of interest and redemption. Although only corporate and institutional investors subscribe to government securities, individual investors are also permitted to subscribe to these securities.

An investor in government securities has the option to have securities issued either in physical form or in book-entry form (commonly known as Subsidiary General Ledger form). There are two types of SGL facilities, viz., SGL-1 and SGL-2. In the SGL-1 facility, the account is opened with the RBI directly. There are several restrictions on opening SGL-1 accounts and only entities, which fulfill all the eligibility criteria, are permitted to open SGL-1 account. The RBI has permitted banks, registered primary dealers and certain other entities like NSCCL, SHCIL, and NSDL to provide SGL facilities to subscribers. A subscriber to government securities who opts for SGL securities may open an SGL account with RBI or any other approved entity. Investments made by such approved entity on its own account are held in
SGL-1 account, and investments held on account of other clients are held in SGL-2 account."^27

2.15. Capital Market Processes

There are various processes that issuers of securities follow or utilize in order to tap the savers for raising resources. Some of the commonly used processes and methods are described below.

A. Initial Public Offering (IPO)

"Companies, new as well as old can offer their shares to the investors in the primary market. This kind of tapping the savings is called an IPO or Initial Public Offering. SEBI regulates the way in which companies can make this offering. New companies can make an IPO if they have a dividend-paying (ability) record of three years. The size of the initial issue, the exchange on which it can be listed, the merchant bankers' responsibilities, the nature and content of the disclosures in the prospectus, procedures for all these are laid down by SEBI and have to be strictly complied with. Exemption may be granted by SEBI in certain cases for minimum public offer or minimum subscription in the case of certain industry sectors like infrastructure or IT or media & communications. Several changes have also been introduced in recent years in the manner in which the IPOs can be marketed. For example they can now take the book building route or they can even be marketed through the secondary market by brokers or DPs. All these changes have been made with the objective of making the process more investor friendly by reducing risk, controlling cost, greater transparency in the pricing mechanism and protecting liquidity in the hands of the investor. Some of the IPOs have
been available for subscription online - where the bids are made in real time and the information is made available on an instantaneous basis on the screen. It is possible to subscribe for IPO shares in Demat form through DPs.  

B. Private Placement

"Many companies choose to raise capital for their operations through various intermediaries by taking what in marketing terms would be known as the wholesale route. The retail route - of approaching the public - is expensive as well as time consuming. This is called in financial markets as private placement. SEBI has prescribed the eligibility criteria for companies and instruments as well as procedures for private placement. However, liquidity for the initial investors in privately placed securities is ensured as they can be traded in the secondary market. But such securities have different rules for listing as well as for trading. Preferential Offer/Rights Issue Companies can expand their capital by offering the new shares to their existing shareholders. Such offers for sale can be made to the existing shareholders by giving them a preferential treatment in allocation or the offer can be on a rights basis, i.e., the existing holders can get by way of their right, allotment of new shares in certain proportion to their earlier holding. All such offers have also to be approved by SEBI which has laid out certain criteria for these routes of tapping the public. These have to be complied with."  

C. Internet Broking

"With the Internet becoming ubiquitous, many institutions have set up securities trading agencies that provide online trading facilities to their clients"
from their homes. This has been possible since all the players in the securities market, viz., stockbrokers, stock exchanges, clearing corporations, depositories, DPs, clearing banks, etc., are linked electronically. Thus, information flows amongst them on a real time basis. The trading platform, which was converted from the trading hall to the computer terminals at the brokers' premises, has now shifted to the homes of investors. This has introduced a higher degree of transparency in transactions. The investor knows exactly when and at what rate his order was processed. It also creates an end-to-end audit trail that makes market manipulation difficult. The availability of securities in Demat form has given a further fillip to this process.

However, the emergence of, what is known as, "day-traders" has resulted in the business environment of brokers which has changed. Investors, who can now trade directly, no longer require their intermediation. Service charges have therefore been declining - all of which has been in favor of investors."30

SPEED-e

"In order to extend the benefits of technological progress to investors, NSDL has launched SPEED-e services. SPEED-e is a internet based facility for clients of all Depository Participants (DPs) that enables the accountholders to submit instructions to their DPs through SPEED-e website on internet. The clients can submit instructions at a time convenient to them from a place convenient to them using SPEED-e website of NSDL. The accountholders can also view the status of their instructions submitted through SPEED-e on the website itself. SPEED-e is expected to greatly reduce the time and efforts required in processing the instructions."31
2.16 Conclusion

In the post-independence period, the size of the capital market remained small. During the first and second five-year plans, the government's emphasis was on the development of the agricultural sector and public sector undertakings. Thanks to steps initiated by the Indian government especially after the post liberalization era. A huge growth has been observed in the aspects of quality and quantity. Huge increase has been observed in the volumes of trade. The changes in the regulatory framework of the capital market and fiscal policies have also resulted in newer kinds of financial instruments (securities) being introduced in the market. Taking into account international experience and needs of the financial markets, NSE launched NCFM (NSE's Certification in Financial Markets). It tests practical knowledge and skills that are required to operate in financial markets, in a very secure and unbiased manner, and certifies personnel with a view to improve quality of intermediation. There are several institutions, which facilitated the smooth functioning of the securities market. They enabled the issuers of securities to interact with the investors in the primary as well as the secondary arena. After going through the conceptual framework of the Capital Market, the assessment of the performance of the market is the main requirement of this study. The assessment of the performance of the Indian Capital market has been dealt with in the next chapter.
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